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Caution the Keynote Of German Monetary Policy

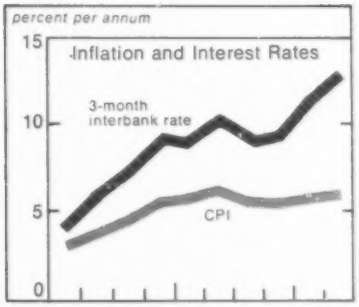
The recent rise in the German mark against the world's major currencies and the subsequent one-point reduction in Germany's Lombard rate have once again focused attention on the policy trade-offs facing Germany's central bank. Last February, the Bundesbank raised interest rates despite the domestic recession, ostensibly to protect a rapidly declining German mark. The Bundesbank felt, quite justifiably, that further declines in the DM would create inflationary pressures that might trigger a wage-price spiral. The real costs of having eventually to control such a spiral outweighed the costs of immediate action on interest rates.

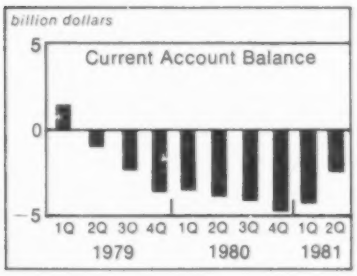
The February measures were partly successful. Although they failed to prevent a further decline in the DM against the U.S. dollar, they helped prevent higher import costs from spreading through the economy. As a result, Germany's international competitiveness improved by some 8% and its trade balance, in volume terms, recovered dramatically. The chief reason for the DM's original weakness—a $14-billion current-account deficit in 1980—now looks set to reverse itself. Indeed, a somewhat stronger DM will bring positive price effects that may make official predictions of a $6-billion current-account deficit for 1982 too pessimistic.

The projected turnaround in Germany's current account, combined with a (still relatively low) 6.5% annual inflation rate, is leading to something of a reassessment of the German currency. A shift of international portfolio preferences in favor of the mark may present the Bundesbank with a new set of choices. The first is reducing German interest rates relative to those overseas (mainly in the United States). The second is holding interest rates constant relative to those abroad, allowing the DM to appreciate further.

The Bundesbank's choice will ultimately involve two judgments: the degree of inflationary pressure now in the economy, and the course of U.S. interest rates. A continued restrictive policy would reduce DM-denominated import prices, which have risen by some 20% over the past year, and probably stiffen employer resolve in the forthcoming wage round. It would, however, further weaken an already sluggish domestic economy. On the other hand, a rapid reduction in rates, which would stimulate domestic demand, would risk internalizing imported inflation and prove counterproductive if the current decline in dollar interest rates proves temporary. The German central bank is therefore likely to adopt a cautious attitude in the short run. Should a consolidation of trends favorable to the DM materialize, particularly after this winter's wage round, a more rapid relaxation of policy would then ensue.

German economic indicators





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Export-dependent Austria looks to Europe for recovery.

Despite a mild recovery in the second half of this year, Austria's economy is expected to show no growth for 1981 as a whole. The inflation rate of just under 7% has eroded disposable incomes, keeping private consumption flat. At the same time, a low rate of capacity utilization and high real interest rates have held back investment spending. Nonetheless, despite what promises to be a mildly restrictive budget, most observers expect a gentle recovery in 1982, with real GDP growth of 2%-3%. The key elements are a hoped-for reduction in the rate of inflation, which should boost real incomes and consumer spending, and faster export growth based on a decline in the real trade-weighted value of the Austrian schilling. A major uncertainty for this export-dependent economy, however, remains the extent of European recovery. If that recovery is delayed by continuing tight monetary conditions, Austria's exports and its overall economic performance would fall short of current expectations.

Israel's economic difficulties are broad-based.

The consequences of economic measures implemented prior to the June elections in Israel are now being felt. Reversing his predecessor's policy, Finance Minister Yoram Aridor slashed indirect taxes and reduced subsidies on many consumer goods. These measures achieved some success in curbing short-term inflationary pressures. In the May-July period, consumer prices advanced at a 61% year-over-year rate, compared with a 133% leap in prices over the course of 1980. The initiatives spurred purchases of consumer durable items, and demand was largely met through a rise in import volume. In addition, the budget deficit widened further and was accommodated through monetary growth. These developments cast doubt on the strength of Israel's future economic performance and have led to some policy revision. Spending plans are being curtailed and subsidies have been cut once again. As a result, the hike in the cost of living in September was 8.1%, bringing the year-over-year inflation rate to 98%. Growth forecasts are now being revised downward, with GNP likely to register only a 2% increase this year following 2.3% in 1980. The external-account outlook is similarly bearish. Israel's current-account deficit may widen to more than $1 billion this year from $880 million in 1980.

Iceland outlook buoyed by energy resources, but high inflation persists.

Although Iceland possesses abundant geothermal energy, it still must import oil for transportation purposes and for its fishing fleet. A new agreement with the USSR ensures that the Soviets will supply all of Iceland's requirements for this year and next, but longer-term plans call for further exploitation of the country's geothermal energy resources. Latest forecasts suggests a 50% increase in energy consumption by 1990, but also allow for an increase in the share of renewable energy sources to 77%. In 1980, 72% of the population had geothermal space heating, and by 1985 the figure should reach 80%. By contrast, the percentage of the population utilizing oil heat is expected to fall from 13% last year to 2% in 1985. Such growing energy independence enhances Iceland's potential for strong economic growth in the future. Indeed, the signs are that, after this year's stagnation, real GDP growth will move toward the 1976-80 average of 3.7%, while the country's debt service ratio should fall from this year's record 15%. The dark cloud over the economy, however, remains a high inflation rate, which, while untamed, will continue to dampen growth. Despite some recent slackening in inflation, prices in 1981 will be about 50% higher than in 1980. This compares with a 58% figure last year and with an average inflation rate of 42% over the last five years.

Dominican Republic policy austerity dampening growth.

The Dominican Republic's international payments position continues weak. The causes stem from overstimulative demand-management policies undertaken from 1979 through mid-1980 and terms-of-trade deterioration. The country's deficit on current account more than doubled to $715 million in 1980 from an average of $340 million in 1978 and 1979, and commercial payments arrears have accumulated rapidly. To check these imbalances, the authorities have since mid-1980 pursued tighter fiscal and monetary policies. These policies have virtually elim-

inated the central government's budget deficit this year from a level equivalent to 6% of GDP in 1979, while monetary growth has been cut to 1% from 16% in 1979. At the same time, import payments have been increasingly channeled to the parallel foreign-exchange market—effectively constituting a partial exchange-rate correction—and greater import restrictions have been imposed. While the adjustment program should narrow the 1981 current-account deficit to some $650 million, it is expected to dampen economic activity and reduce price pressures. Real GDP is thus expected to grow by 3%-3.5% this year, down from an average of 5% in 1979 and in 1980. And the country's annual average inflation rate is expected to be about 8% in 1981, compared with 13% in the previous two years.

Japan moving decisively to cut public deficit.

In striking similarity to the current U.S. strategy, Japan's government is attempting to slash spending to ease its burgeoning national debt. The government, whose debt is expected to reach 82 trillion yen ($390 billion) by the end of March 1982, will have to finance 26.2% of its fiscal 1981 spending through bond issues, compared with only 6.5% in the United States and 12% in Germany. The Suzuki government has pledged to reduce this level to zero by the end of fiscal 1984. To lower its bond issue by 1.8 trillion yen in the next fiscal year without raising taxes, the government has instructed most departments to hold their spending requests to this year's level. About the only increased allocations allowed in the draft budget are a 7.5% rise in defense spending and an 11.4% increase in foreign aid. The Suzuki government has also presented parliament with an administrative reform proposal designed to trim government spending on various social programs. Although most of these spending cuts are expected to be enacted, the "guns-versus-butter" debate could be heated and might ultimately result in a smaller rise in defense spending.

Pakistan applies Islamic principals to financial sector.

Of all Islamic nations, Pakistan has so far gone the furthest in applying Islamic principles to its financial sector. In accordance with the Koran, the government has sought to replace the payment of interest with markups or equity participation plans that reward investors with a share of profits and losses. Since January 1, 1981, domestic banks have been required to offer, along with conventional interest-bearing accounts, new zero-interest savings accounts known as Profit-Loss Sharing (PLS) deposits for investment in profit-sharing ventures. Profits or losses earned from these ventures are distributed among depositors on a pro-rata basis after deductions are made for normal banking expenses. As of July, such PLS deposits constituted about 4.5% of Pakistan's total bank deposits. Their yields during the first six months of 1981 ranged from 8.5%-15.25%, depending on maturity, compared with returns of 7.5%-12% on conventional, interest-bearing accounts. Despite these attractive returns, there is still great uncertainty as to how the interest-free system will evolve. And it is feared that this uncertainty will depress Pakistan's already-low domestic savings rate.

South African external accounts deteriorating.

South Africa's trade balance has worsened steadily over the course of 1981. For the first eight months of the year, the country registered a $300-million deficit, in sharp contrast to a $5.4-billion surplus for the same period last year (after adjustment for a 6% depreciation of the rand vis-à-vis the U.S. dollar). Total exports fell 18% to $13.9 billion, and imports rose 23% to $14.2 billion. Sales to the United States—since 1978 South Africa's main trading partner—fell 11% to $1.5 billion, largely reflecting reduced South African sales of Krugerrands, platinum, and diamonds. Imports from the United States, however, increased 38% to $2.3 billion, spurred by relaxed U.S. export restrictions under the Reagan administration on the sale of such products as medical equipment and pharmaceuticals, as well as computer equipment, to the military. Assuming some strengthening of gold prices in the remaining months of 1981, the trade account is likely to end the year in rough balance, after a $7-billion surplus last year. This suggests a similar swing in the current-account balance to a deficit of about $3.5 billion.

Consolidation in the Business Sector

Speculation of a "merger mania" earlier this year was fed by the large number of companies that had lined up huge loan commitments either to acquire other companies or resist takeover. Many market analysts feared bidding wars would lead to a credit crunch and soaring interest rates as the credit lines obtained were drawn down. These fears have not yet been realized. But a weakening economy, high interest rates, and reduced credit availability may have led to a different form of consolidation in the business sector—bankruptcies. Mergers may therefore be the more desirable response to present economic conditions.

Business failures have increased dramatically since early 1980. According to Dun and Bradstreet, the failure rate per 10,000 businesses averaged slightly less than 29 during the expansion years of 1976-79. But as the economy nosedived in the second quarter of 1980, the failure rate jumped to 46. The first nine months of 1981 saw a further 40% surge in bankruptcies, which propelled the failure rate to nearly 60.

Although the doubling of the failure rate during the last two years (compared with the previous four-year period) appears worrisome, the recent level of bankruptcies is not high by historical standards. Between 1950 and 1965, for example, the failure rate averaged nearly 50, and from 1880 through 1933, it approximated 100. Nonetheless, the rise in bankruptcies has elicited more vocal protests over high interest rates.

The role of interest rates in increasing the number of bankruptcies, however, is not as obvious or important as some critics of Federal Reserve policy suggest. Money, or credit, is only one input to the production process (although one whose importance increases in a highly inflationary environment). Restraint of money-supply growth by the Fed has raised the cost of credit—at least in the short run—and has put upward pressure on prices. Business firms do have recourse, however. They can either pass through higher credit costs or economize on the use of credit.

With the contraction of the economy in the second and third quarters of 1981, and further prospective declines in real output seen well into 1982, many firms are finding it difficult to pass on increased borrowing costs in the form of higher prices. Moreover, creditors are increasingly concerned about business' outstanding debt levels. Consequently, the desired level of inventories is expected to shrink, some capital projects will be stretched out or cancelled, and further cash-management innovations will be sought to conserve money and credit. In the short run, limits to such conservation measures are expected to keep the failure rate high—and possibly rising. To the extent that mergers enhance efficiency, or improve the access of the enlarged firms to credit, they are a sound response.

Bailout or Deregulation

Treasury Secretary Regan's testimony last week before the Senate Banking Committee provides added insight into the dilemma of current bank regulation policies. In the first place, as Mr. Regan noted, the range of difficult policy questions is extraordinarily wide. They include deposit and loan-rate ceilings, increased operating powers, mergers, geographic expansion, and financial assistance for ailing institutions.

In the second place, there are conflicts between the near-term objectives of regulatory policy and the longer-term goal of fostering greater competition in financial markets. In the short run, there seems to be a pronounced emphasis within government circles on defense. This is aimed chiefly at the weakened thrift industry, some elements of which are under considerably more duress than others. All-savers accounts, for example, were established as a means of lowering the costs of acquiring deposits. Also being considered is liberalizing the terms under which deposit insurance agencies may advance funds to severely pressed institutions. A major constraint on the latter, however, is the potential for large increases in federal spending and borrowing. The process of deregulation itself is further strained because of pressures from thrifts and others for insulation from market forces. The rollback of the ½-point rise in savings deposit ceilings and strong opposition to other forms of ceiling relaxation are foremost examples.

From a longer-term perspective, regulators are faced with a situation in which restrictive regulation and sharply declining transactions costs are rapidly stimulating a more active role in financial services by non-deposit entities. This in turn is eroding the role played by banks and thrifts in loan and deposit markets. Secretary Regan's support for such liberalized powers as expanded non-consumer banking functions (for thrifts) and certain investment banking activities (for banks) points to a greater eventual convergence of service capabilities among participants in financial markets.

How to get from the short-run protection atmosphere to one of enhancing greater competition is frustrating legislators and practitioners alike. Secretary Regan touched on one element regarded by many as a central vehicle for at least part of this transition—interindustry and interstate mergers and acquisitions. Various forms of combinations, not only among banks and thrifts but among securities and insurance firms as well, would provide greater institutional strength and, of course, stimulate functional convergence.

In the past, crisis environments often tended to generate more, not less, protection and regulation. There may be cause for some optimism this time around, however. The speed with which the "unregulated" financial-service entities have expanded their positions is clear testimony to the punishing effects of regulatory burdens on depository institutions. Those designing regulatory changes can hardly ignore this reality.

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1980		BALANCE OF PAYMENTS						MONEY AND BANKING						COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	12-month changes: consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars, October 21, 1981	change from year earlier	current monetary conditions	
Argentina	Economy in recession, with industrial sector operating at 50% of capacity.	June	+ 46%	117.0	$4,333	June	3,818	— 53%	4.7	0	Export gains spur rise in reserves.	Sept.	+ 119%	July	+ 67%	.000125	— 80%	Interest rates decline as demand falls.	Argentina
Barbados	Exports and tourism fall off as result of weak U.S. and European economies.	May	— 1%	0.8	3,055	Aug.	56	— 23%	1.2	2	Reserves down $30 million since April.	July	+ 14%	June	+ 16%	.5200	+ 5%	Central bank and commercial interest rates increase.	Barbados
Bolivia	New mining law allows free external marketing, permits state companies to set up joint ventures.	June	— 7%	6.1	1,100	Aug.	80	— 49%	1.2	71	Total debt is $3.7 billion, with reserves negligible.	June	+ 27%	June	— 2%	.0425	+ 4%	Net foreign assets down.	Bolivia
Brazil	Inflation rate continues to fall; industrial sector in recession.	Aug.	+ 18%	237.2	1,991	Aug.	5,438	— 7%	2.7	0	Trade shifts into surplus as imports lag.	Sept.	+ 110%	June	+ 57%	.0092	— 47%	Availability of cruzeiro credit limited.	Brazil
Chile	Banking laws revamped to break up trusts and stave off financial-market disruption.	July	— 15%	22.8	2,060	Aug.	3,406	+ 21%	5.7	65	Current-account deficit in 1981 likely to be more than double 1980.	Aug.	+ 18%	June	+ 29%	.0265	2%	Real interest rates higher than at end-1980.	Chile
Colombia	Important new oil discovery and rising output brighten petroleum prospects.	Apr.	— 31%	36.8	1,360	Aug.	4,454	+ 2%	10.5	0	Trade deficit reemerges as coffee earnings drop.	July	+ 29%	Feb.	+ 26%	.0200	13%	Private credit conditions restrictive.	Colombia
Costa Rica	Rescheduling of $2.6-billion public external debt now under way.	May	— 6%	4.6	2,063	Aug.	149	+ 53%	1.3	104	Foreign-exchange gap of $1.25 billion seen thru 1982—25% of 1980 GDP.	May	+ 30%	Apr.	+ 37%	.0600	50%	Liquidity is tight.	Costa Rica
Dominican Rep.	Tight fiscal and monetary stance slowing 1981 GDP growth to about 3%-3.5%.	June	+ 39%	6.9	1,280	Aug.	205	— 3%	1.5	29	Trade gap expected to be halved in 1981 from $500 million in 1980.	May	+ 8%	June	+ 1%	Par	—	Interest rates raised 1% to maximum of 8.5%.	Dominican Rep.
Ecuador	Larger government deficit prompts drive for increased revenues and spending cuts.	Aug.	— 1%	11.0	1,321	July	704	— 17%	3.8	0	Government providing some support of exchange rate.	July	+ 16%	Apr.	+ 34%	.0345	10%	Bank liquidity under pressure.	Ecuador
Guatemala	Economic deterioration continues in light of political turmoil.	Dec.	+ 1%	7.9	1,090	Aug.	257	— 54%	2.1	0	Foreign currency restrictions tightened to check capital flight.	Apr.	+ 13%	June	— 2%	Par	—	Money supply contracting.	Guatemala
Mexico	Upward revision of official GDP statistics show rapid 8.5% growth in 1978-80.	Apr.	+ 54%	167.0	2,300	Mar.	3,084	+ 39%	1.6	0	Current-account deficit expanded by 78% in first-half 1981.	Sept.	+ 28%	May	+ 41%	.0400	8%	Fiscal pressures speed money supply growth.	Mexico
Nicaragua	State emergency declared, with bans on strikes, import tax hikes, and public spending cuts.	Dec.	— 22%	1.9	730	Nov. '79	85	+ 42%	4.5	25	Agreement on restructuring $180-million in debt owed by nationalized banks.	Dec.	+ 27%	Aug.	+ 90%	.1000	1%	Credit conditions restrictive.	Nicaragua
Panama	More efficient operation of state-owned sugar and cement firms improve earnings.	May	+ 29%	3.5	1,805	July	101	+ 23%	0.8	97	Export earnings boosted by high shrimp prices.	June	+ 7%	May	+ 14%	Par	—	Credit to public sector declines.	Panama
Paraguay	Strong increase in official export earnings through June 1981 attributed to timber, cotton, soybeans.	June	+ 15%	4.6	1,505	Aug.	785	+ 7%	16.3	0	Pressures on free exchange rate emerging.	Apr.	+ 16%	June	+ 17%	.0080	0	Domestic credit is scarce.	Paraguay
Peru	Fiscal budget deficit expanding sharply.	July	— 17%	17.0	955	Feb.	1,756	— 26%	7.5	393	Widening current-account gap leads authorities to boost foreign loan ceiling.	Sept.	+ 72%	June	+ 47%	.00225	— 42%	Net foreign assets declining.	Peru
Trinidad	Manufacturing output hampered by labor, electricity, and water-supply problems.	Apr.	+ 10%	5.4	4,780	Aug.	3,038	+ 28%	13.2	0	Higher oil export prices offset volume drop.	May	+ 15%	May	+ 24%	.4300	+ 5%	Bank deposit growth slows down.	Trinidad
Uruguay	Government eliminates exchange-rate guarantee enacted in March to boost confidence in peso.	May	+ 64%	9.8	3,379	June	633	+ 35%	4.7	0	Wheat expected to be exported for first time since 1976-77.	July	+ 32%	Dec.	+ 52%	.0920	11%	Interest rates far higher than international rates.	Uruguay
Venezuela	Social spending to have priority in 1981-85 development plan.	May	+ 24%	51.4	3,690	Aug.	8,060	— 1%	8.8	0	State entities may now secure medium-term Euroloans.	July	+ 17%	Mar.	+ 15%	.2330	0	Interest rates liberalized.	Venezuela

World Interest Rates

market rates of Oct. 21, 1981; bond yields as of Oct. 16, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 16.00	18.31	15.50	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	7.25
Day-to-Day Money	15.50 Oct. 22	19.50	15.50	10.95	16.75	11.00	20.125	12.875	8.50	7.4375
Treasury Bills 91-day, Middle Rates	13.22 discount basis	18.05	15.437	15.75	n. a.	n. a.	19.00 86 day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	14.375 finance paper discount basis	19.00 finance paper 15% tax w/h	14.26	12.90 Certified	16.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	14.75	18.80 15% tax w/h	15.437	12.90 Certified	not traded	9.90	23.90	no market	11.00	no market
Government Bonds Long-term, new and old issues, average yield	15.00	17.20	15.58	10.016 20% tax w/h	16.39	10.12	20.67	11.94	6.00	8.41
Industrial Bonds prime, long-term, new and old issues, average yield	15.85 Aa Industrials	18.125	16.75	19.691	17.89	10.15	20.49	13.06	6.9125	7.18
Bank Short-Term Rate to Best Borrowers (prime rate)	18.00	20.00	16.50	18.00	19.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	14.50	10.50	6.75
Bank Time Deposits 3-month	15.25 Cert. of Dep.	16.375	16.187	15.20	16.125	11.30	10.75	12.875 large deposits	9.75 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	16.50	no market	16.5623	no market	17.50	11.4375	no market	12.8125	11.125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8304	1.8140	.0262	.1750	.4387	.00083	.3984	.5265	.00427
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.00 *D*	0.30 *P*	2.00 *D*	1.00 *D*	5.00 *P*	6.00 *D*	3.00 *P*	5.00 *P*	9.00 *P*

Eurodollar Deposits
(London, interbank, bid)
October 22

7-day	15.8125
1-month	16.00
3-month	16.4375
6-month	16.75

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.705
U.S.-Canada Treasury Bills	−1.818
U.S.-Canada Finance Co. Paper	−2.364
Eurodollars-U.K. Local Auth. Deposits	−0.2375

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	16.875
Over 7 yrs.	16.562
DM Bonds	
7 yrs. and under	10.75
Over 7 yrs.	10.50

Gold Price
London afternoon fixing
429.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	10.9 (Aug.)	12.5 (Sept.)	11.4 (Sept.)	13.6 (Aug.)	6.6 (Sept.)	18.3 (Sept.)	7.5 (Sept.)	4.1 (Aug.)
Industrial production*	−0.8 (Sept.)	4.6 (July)	−3.5 (Aug.)	−5.9 (Aug.)	0.9 (Aug.)	−3.0 (Aug.)	−2.6 (Mar.)	5.2 (Aug.)
Trade balance† *(billions of local currency units)*	−$5.61 (Aug.)	C$0.36 (Aug.)	£0.01 (Sept.)	−FF8.46 (Sept.)	−DM0.06 (Aug.)	−Lit.1,040 (Aug.)	−SF0.94 (Sept.)	¥407 (Aug.)
Money supply (M1)*	4.9 (Sept.)	4.0 (Aug.)	12.6 (June)	12.1 (May)	1.4 (July)	11.9 (April)	2.4 (June)	4.6 (June)
Velocity of money (M1)*	12.9 (Mar.)	−0.14 (Dec.)	9.8 (Dec.)	n. a.	0.7 (Mar.)	4.6 (Mar.)	n. a.	13.0 (Mar.)
Reserves minus gold *($ million, change from previous month)*	400 (Aug.)	983 (Aug.)	30 (Aug.)	−603 (July)	−1,463 (Aug.)	732 (Aug.)	−210 (Aug.)	144 (Aug.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

Policy Constraints Limit Swedish Growth

Sweden's economic performance in recent years has been weak, even by European standards. Its major problems stem from insufficient adjustment to high energy prices and to a world in which competition for export markets has become intense. These difficulties in turn result largely from the economy's socialist orientation and a political environment in which corrective economic policies are sometimes difficult to implement. Nonetheless, Sweden's possession of the fourth highest GDP per capita in the industrialized world (nearly $15,000) allows it sufficient flexibility to adjust to the new economic realities.

Insufficient economic adjustment

Sweden's adjustment to higher energy prices has been blocked primarily by resistance to downward wage adjustment. The run-up in energy prices necessitates that the average level of real wages and of real profits be reduced to maintain full employment—a high priority for Sweden. It also requires that resources be transferred toward less energy-intensive processes and that substitution and conservation efforts be stepped up.

Substantive progress has been made on the energy conservation and substitution fronts. The Swedish authorities have imposed tax increases to reduce consumption of oil products and are aiming to cut oil imports from the current 26 million tons annually to between 14 and 17 million tons per year by 1990. Furthermore, plans have been formulated to replace oil imports with imported coal and with peat from forests. Significantly, however, Sweden's strong labor unions have resisted cuts in real wages. This has contributed to a fall in profits and in investment, and also to a rise in rates of unemployment and inflation.

Gross fixed investment in real terms grew only slightly in 1980 and is expected to decline by some 8% this year. And although still low, Sweden's unemployment rate is expected to average 2.3% in 1981, up from 2% last year. The rate of consumer price rise, which surged to 13.7% last year from 7% in 1979, is forecast to remain at about 13% this year. Also dampening business conditions is the government's large and growing budget deficit, which is forecast to widen to 11.2% of GDP in 1981. Rapid increases in public spending in the early 1970s gave a large boost to the deficit, which has expanded further in recent years because of a recession that has cut revenues and increased welfare-related expenditures (see table).

The vital export sector has also lost momentum. With recession worldwide crimping export demand, certain export industries are facing stiff competition—especially from the newly industrialized countries—and it is questionable whether they will regain their former market position. Adjustment to the loss of competitiveness in some industries requires flexibility across industries and internal resource mobility, but the Swedish system does not encourage these traits.

Domestic Indicators

	1979	1980	1981 est.
Real GDP Growth, %	3.9	1.4	−1.0
Inflation Rate, %	7.0	13.7	13.0
Money Supply (M3) Growth, %	16.5	12.3	9.5
Central Government Borrowing Requirement, % *of GDP*	9.6	10.5	11.2

High marginal rates of taxation dampen entrepreneurial initiative and innovation, while the geographic mobility of labor is discouraged by job-protection schemes and by existing arrangements for providing low-cost housing. Reflecting these obstacles, export growth has waned. Merchandise exports are projected to decline by 5% this year after 12% growth in 1980. However, with import demand down and a reduced services deficit, Sweden's trade and current-account deficits are expected to narrow significantly this year (see below). Moreover, Sweden's large supply of international reserves—$3.6 billion, excluding gold, at the end of August—and continued healthy capital inflows make deficit-financing no problem. And although Sweden is a debtor nation, with a net foreign debt of about $10 billion at the start of 1981, the ratio of debt to a GDP of $123 billion last year was only 8%, and the country possesses substantial overseas assets.

Current Account Balance

(billion $)

	1979	1980	1981 est.
Imports, *c.i.f.*	28.7	33.5	29.5
Exports, *f.o.b.*	27.5	30.9	29.3
Trade Balance	−1.2	−2.6	−0.2
Current Account Balance	−2.7	−5.2	−3.2
Reserves/Average Monthly Imports	1.72	1.18	1.39

Compromises limit policy effectiveness

The political environment in Sweden is such that no party commands an overall majority. Consequently, coalition governments are the norm. And the Swedes generally seek complete consensus on policy initiatives,

Policy Constraints Limit Swedish Growth *(continued from page 7)*

respecting the wishes of minorities. These features preclude the adoption of potentially divisive policies, even if favored by the majority. It is thus no surprise that the recent performance of the Swedish economy reflects short-term measures introduced by the government, rather than a coherent, long-term economic policy.

Already this year, a series of short-term policy responses to economic pressures have occurred. Sweden began 1981 with a relatively high, but slowing, rate of economic growth and with an expanding current-account deficit. Despite public spending cuts announced in October 1980, the budget deficit was expected to widen to more than 60 billion kronor ($11.5 billion). Wages were rising faster than in many other industrialized countries, and international competitiveness was declining.

This gloomy scenario triggered a run on the krona in January 1981, which the government countered with higher interest rates. The country's prospects improved still further in February with a two-year wage settlement that provided for wage increases of about 7.1% over two years. Spillover effects and increased employers' contributions, however, meant that the increase in labor costs in 1981 would be approximately 9.5%, while those in 1982 would be about 6%. In addition, the agreement contained a provision for indexation whereby wages would climb still higher if prices rose by more than a specified amount.

The end of April saw a crystallization of the political constraints. The coalition of non-socialist parties disagreed over taxation policies, and the prime minister resigned—only to form a new coalition government immediately afterward. It was clear, however, that the new government would be no more able to introduce strong policies than the old, and that no new initiatives could be expected before the next election—scheduled for September 1982.

By September, the strength of the U.S. dollar was causing considerable problems for Sweden's economy. With the krona stabilized against a basket of currencies, its depreciation against the dollar had to be matched by an appreciation against such other currencies as Germany's mark, even though costs in these countries were rising more slowly than in Sweden. Swedish exporters thus found themselves increasingly unable to compete, and on September 14 the authorities announced a 10% devaluation.

Theoretically, the devaluation would have led to higher prices, and would have thereby—assuming money wages stood unchanged—provided a means of reducing Sweden's high level of real wages. But since wage indexation formulas would have raised wages in line with prices (which would be bid up because of the devaluation's impact on import costs), the government was forced into a policy compromise. It announced a price freeze for the remainder of 1981, together with a reduction in value added (sales) taxes to hold rises in the price index below the trigger point. Thus, one problem was dealt with at the expense of another. Meanwhile, the price freeze will hinder a restoration of profits and a consequent increase in investment, while the value added tax reduction will cut into the government's tax revenues and further widen the budget deficit.

Implications for growth in 1981-82

The net result of these policy maneuverings and economic influences will be negative real GDP growth of an estimated 1% in 1981, with large declines in private consumption and investment. Domestic business activity will be hurt by rising input costs matched by restrictions on price increases, which will squeeze profit margins. And although the central bank has cut its discount rate to 11% from 12% (the first rate reduction since 1978) to spur investment and ease inflation, the large government deficit is expected to keep interest rates high and credit conditions tight.

The export weakness seen this year may reverse itself slightly in response to the September devaluation, but not sufficiently to prevent a decline in the value of merchandise exports for the year. It appears that only the public sector will show any real buoyancy this year—at the cost of a growing deficit.

Prospects for 1982 are only slightly brighter. The government is likely to introduce a reflationary package in time for the September elections. In the absence of a stimulative package of measures next year, however, private consumption and investment could fall by an additional 1%, owing largely to the continuation of an unfavorable business climate. In any event, public consumption and investment are each scheduled to grow by 1.5%. The stimulus of government spending, together with a forecast 3% growth in exports, should prevent GDP from falling again in 1982, keeping it at about its 1981 level.

In sum, although Sweden's current and prospective economic position is bearish, the country has demonstrated an ability to resolve its difficulties in the past. If it succeeds in forging the necessary political consensus to implement long-term corrective economic policies—possibly after the 1982 elections—it can lift its economy out of the doldrums. While corrective policies will entail sacrifices, a short-term reduction in living standards would not be likely to have serious consequences in a country with one of the highest per capita GDPs in the industrialized world.

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